

Message Text

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47/14

ACTION SS-14

INFO OCT-01 ISO-00 EUR-08 SP-02 TRSE-00 NSC-05 NSCE-00

FRB-03 CIAE-00 EB-03 ONY-00 SSO-00 /036 W

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O 191210Z NOV 76

FM AMEMBASSY LONDON

TO SECSTATE WASHDC IMMEDIATE 7859

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C O R R E C T E D C O P Y (TEXT ON ORIGINAL GARBLED)

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TAGS: EFIN, UK

SUBJECT: SITUATION REPORT, NOVEMBER 19

REF: (A) STATE 267168; (B) LONDON 18575

1. BANK CREDIT SQUEEZE: FACED WITH CONTINUING MONEY SUPPLY (M3) GROWTH IN EXCESS OF THE 12 PERCENT TARGET, HMG REIMPOSED SEVERE RESTRICTIONS ON BANK CREDIT EXPANSION. THESE RESTRICTIONS, INITIALLY IMPOSED IN 1973 BY THE HEATH GOVERNMENT, WERE LIFTED IN FEBRUARY 1975. KNOWN AS THE "CORSET," THE RESTRICTIONS LIMIT THE RATE OF GROWTH OF BANKS' INTEREST BEARING ELIGIBLE LIABILITIES (IBELS) TO 3 PERCENT OVER THE NEXT 6 MONTHS AND TO 0.5 PERCENT PER MONTH FOR THE FOLLOWING TWO MONTHS. FAILURE TO REMAIN WITHIN THIS GROWTH RATE RESULTS IN PROGRESSIVELY STIFFER PENALTIES IN THE FORM OF NONINTEREST BEARING SPECIAL DEPOSITS WITH THE BANK OF ENGLAND. THIS DRACONIAN SQUEEZE BECAME INEVITABLE AS BANK LENDING TO THE PRIVATE SECTOR CONTINUED TO RISE IN THE FACE OF RECORD INTEREST RATES. WHILE IT SEEMS LIKELY THAT MUCH

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OF THIS PRIVATE SECTOR BORROWING CAME IN ANTICIPATION

OF THE IMPOSITION OF CONTROLS RATHER THAN BECAUSE OF ANY RISE IN THE LEVEL OF ECONOMIC ACTIVITY, IT HAD THE EFFECT OF SPURRING THE GROWTH OF M3. THE EFFECT OF THE SQUEEZE WILL BE FELT PARTICULARLY BY CONSUMERS AND PRIVATE HOMEBUILDERS AS BANKS BECOME VERY SELECTIVE IN THEIR LENDING AND PRIORITY IS GIVEN TO INDUSTRIAL BORROWERS.

2. HM TREASURY ANNOUNCED LATE THURSDAY AFTERNOON CHANGES IN THE U.K.'S EXCHANGE CONTROL REGULATIONS WHICH AIM TO ELIMINATE U.K. BANK FINANCING OF THIRD COUNTRY TRADE. THE MEASURE ALLOWS EXISTING LINES OF CREDIT TO REMAIN IN FORCE FOR ONE MONTH, AND FOR CONTRACTS CURRENTLY COMMITTED TO BE EXECUTED. BUT STERLING CREDIT PROVIDED BY U.K. BANKS FOR FOREIGN TRADE WILL IN THE FUTURE BE RESTRICTED TO THE FINANCING OF TRADE BETWEEN THE REST OF THE WORLD AND SCHEDULED TERRITORIES (THE U.K., INCLUDING THE CHANNEL ISLANDS AND THE ISLE OF MAN, THE REPUBLIC OF IRELAND AND GIBRALTAR). THE MEASURES ALSO TERMINATE U.K. MERCHANTS' USE OF OFFICIAL EXCHANGE TO FINANCE THIRD COUNTRY TRADE. THE RESOURCES ARE EXPECTED TO BRING A SHORT-LIVED INCREASE IN THE DEMAND FOR STERLING ON THE ORDER OF A FEW HUNDRED MILLION POUNDS.

3. AN ARTICLE BY FRANK VOGL IN THE TIMES OF NOVEMBER 19 STATED THAT AMERICAN OFFICIALS AND FINANCIERS SEE LITTLE HOPE IN NEAR-TERM FUNDING OF STERLING BALANCES. THE ARTICLE STATES THAT THE BRITISH GOVERNMENT IS INTENSELY HOPEFUL OF A SECOND LOAN TO FOLLOW ON THE HEELS OF THE IMF CREDIT. VOGL SUGGESTS THAT THE CHANGE OF ADMINISTRATION WILL DELAY OFFICIAL ACTION, WHILE THE PRIVATE MARKETS SEE LITTLE POSSIBILITY OF SUCH A LARGE OPERATION BEING CARRIED OUT IN PRIVATE CREDIT MARKETS.

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4. FOREIGN EXCHANGE AND FINANCE: THE MONEY MARKET EXPECTS THAT THE MINIMUM LENDING RATE (MLR) WILL FALL BY L/4 OR L/2 PERCENT AT TODAY'S TREASURY BILL AUCTION. PEOPLE IN THE MARKET INDICATE THAT THE BANK OF ENGLAND DOES NOT, HOWEVER, WISH A SHARP FALL AND SO WILL OPPOSE ANY DECREASE AS LARGE AS 3/4 PERCENT. GILTS ON THURSDAY GENERALLY INCREASED ON THE STRENGTH OF EXPECTATIONS OF AN MLR FALL, AND OF THE APPROACH OF A NEW ECONOMIC PACKAGE, ALTHOUGH SOME SHORT-DATED GILTS, NATURALLY, SHOWED PRICES EASING. THERE WAS CONTINUED INTEREST IN THE EXHAUSTED TAP, THE 14 PERCENT 1982, AND THE FINANCIAL TIMES REPORTED THAT THE GOVERNMENT BROKER HAD BEEN A SELLER OF THE 15-1/4 PERCENT 1996 AT 97-3/4. THE MONETARY MEASURES ANNOUNCED LATE ON THURSDAY CAME TOO LATE TO AFFECT TRADING ON THAT DAY. FRIDAY TRADING IN GILTS WAS HECTIC, AS STRONG DEMAND FOR THE LONG TAP DEVELOPED. THE GOVERNMENT BROKER SOLD AT 97-3/4 BEFORE WITHDRAWING, AND FURTHER TESTS ARE ANTICIPATED DURING THE DAY. ON THE AVERAGE, LONG GILTS HAVE SHOWN PRICE INCREASES OF 3/8 WHILE SHORTS INCREASED 1/8, TRANSACTION VOLUME BEING QUITE HEAVY. STERLING SHOWED LITTLE CHANGE DURING LONDON TRADING ON THURSDAY, CLOSING AT U.S. DOLLARS 1.6590, DOWN 0.1 CENTS ON THE DAY, ALTHOUGH THE TRADE-WEIGHTED DEPRECIATION SINCE THE WASHINGTON CURRENCY LIMITED OFFICIAL USE

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AGREEMENT NARROWED TO 44.8 FROM WEDNESDAY'S CLOSE OF 45.1. THE ANNOUNCEMENT BY HM TREASURY AND BANK OF ENGLAND OF NEW MONETARY AND FOREIGN EXCHANGE CONTROL MEASURES ENGENDERED SUBSTANTIAL BUYING IN NEW YORK WHERE THE POUND ROSE 2-1/2 CENTS IN AFTERNOON TRADING. ON FRIDAY MORNING IN LONDON THE POUND CONTINUED TO TRADE AT LEVELS IN EXCESS OF U.S. DOLLARS 1.68, AFTER OPENING ABOUT U.S. DOLLARS 1.69. EQUITY PRICES INCREASED ON THURSDAY AS THE FINANCIAL TIMES (FT) INDEX OF 30 INDUSTRIAL STOCKS ROSE FROM 311.1 TO 317.0. EARLY FRIDAY TRADING SAW PRICES FALL SHARPLY AS THE FT INDEX FELL TO 313.8 AT 10:00, AS NEWS OF THE CREDIT SQUEEZE WAS FULLY FELT IN THE MARKET.

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